Yardeni Research

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Morning Briefing

On The Fed & AI, Italy's Growth & Q4 Earnings

Check out the accompanying chart collection.

Executive Summary: FOMC officials agree: AI proliferation is a seismic macroeconomic force that will impact GDP growth, inflation, and the labor market. But they're divided on the precise impacts and timing. Today, Melissa reads between the lines of Fed officials' public statements concerning AI to tease out the implications for monetary policy. Paradoxically, the reasoning of both the AI bulls and the AI bears implies holding the federal funds rate right where it is. … Also: Italy's economy is on a roll. William discusses why, drawing comparisons to Japan's economy. … And: Joe's data on the Q4 earnings of S&P 500 companies suggest record-high earnings and broad-based strength across sectors.

Fed & AI: Both Extremes of the AI Debate Suggest Rates on Hold. Federal Reserve officials have delivered more speeches on artificial intelligence (AI) in the past six months than in the prior two years combined. AI has moved from a curiosity to a core macro variable. Every participant on the Federal Open Market Committee (FOMC) now treats it as a first-order force shaping GDP growth, inflation, and the labor market.

What strikes us is this: Fed officials hold polarized views on AI's economic effects and their timing, yet the monetary policy implications of both poles look the same. The AI bulls argue that a productivity boom is raising the neutral rate of interest, so the federal funds rate (FFR) can stay where it is for longer without being restrictive. The AI bears argue that if AI displaces workers while simultaneously raising output, cutting the FFR could stoke inflation without easing labor-market pain. They likewise believe that rates should remain unchanged.

In other words, AI adoption will have a tremendous impact on economic growth and the job market, all agree. But its impact on interest rates may be small. The Street still expects one or two FFR cuts this year.

Here's a synthesis of specific officials' recent AI-related observations (*Table 1*):

(1) *AI adoption is running at historical speed—bullish.* Fed Governor Michael Barr's February 17 *speech* reframed the debate from "is this real?" to "how fast is it moving?" Generative AI adoption in the workplace since ChatGPT's late-2022 launch has matched the pace of computer adoption after IBM introduced the PC in 1984. The share of large firms using generative AI rose from 33% in 2023 to 79% in 2025.

Fed Vice Chair Philip Jefferson observed in a November 7 *speech* that the adoption of generative AI rose from roughly 30% to 45% in just the six months through July 2025.

Barr concludes that the effects of AI proliferation are likely to be inflationary and "unlikely to be a reason for lowering policy rates." That's because faster AI adoption argues against easing, which would add further fuel to inflation.

(2) *Productivity boom case rests on capital spending, earnings—bullish.* Fed Governor Christopher Waller makes the classic techno-optimist case: Capital and labor are complements, not substitutes. In his October 15 *speech*, Waller noted that the US capital stock is seven times larger than in 1950, yet unemployment is roughly unchanged. History, he argues, shows technology raises employment and living standards over time. Waller's closing line was telling: Policymakers must "let the disruption occur." We read that as: Leave rates where they are unless inflation demands otherwise.

Chair Jerome Powell reinforced the point in October during his *press conference*, observing that AI capex is "one of the big sources of growth in the economy." He highlighted the differences between today's AI capex wave and the capex wave during the tech boom of 1999. AI leaders "actually have earnings," he noted, and are investing in tangible infrastructure. He called the spending "a big deal," but not "particularly interest rate sensitive." Separately, Powell has observed that labor-force participation is edging lower as the population ages.

The implication: If AI lifts productivity and expands capital spending, it could help offset the drag from slower labor-force growth. In a "graying economy" (i.e., as Baby Boomers exit the workforce), stronger productivity may do more of the heavy lifting. In that scenario, there is little urgency to adjust monetary policy.

(3) *Productivity payoff depends on ideas, not just adoption—bearish.* In her February 23 *Economic Letter*, San Francisco Fed President Mary Daly. invoked the example of factory electrification in the early 20th century. Swapping steam for electric motors was progress, but the real gains came when factory floors were redesigned around the new power source. Technology enables transformation; ideas unlock it.

Daly *reports* that firms remain in an "interrogation phase," testing AI before committing to large-scale hiring or restructuring. That says to us: The productivity payoff may lag the adoption headlines. If so, there's little urgency to adjust policy.

(4) *Job displacement to precede job creation—bearish.* Governor Lisa Cook sees a policy trap. In her February 24 NABE *speech*, she called AI "the most significant reorganization of work in generations." Invoking Schumpeter's creative destruction—the idea that innovation destroys old jobs before creating new ones—she emphasized that the transition can be painful. If AI simultaneously boosts productivity and raises unemployment, conventional rate cuts could prove counterproductive, stoking inflation without alleviating displacement.

In sum, if unemployment rises for structural rather than cyclical reasons, the Fed's traditional playbook may not apply. In a debate this consequential and full of uncertainty, doing nothing may be the most deliberate move of all.

(5) *Incoming Fed chair dissents.* Kevin Warsh, who was recently nominated to be the next Fed chair, believes AI-driven productivity gains will be significant and deflationary. So he intends to push the FOMC to lower the FFR. He will clearly get some pushback from his new colleagues.

Italian Economy: Gaining on Japan. There's a joke in European political circles that when anyone utters the catchphrase "whatever it takes"—as President Donald Trump has been doing regarding Iran—Mario Draghi gets €0.50. The reference here is to the famous *pledge* by former Italian Prime Minister Draghi back in 2012 when he helmed the European Central Bank during a crisis in the region's debt markets. This mantra is notable not just because Trump is *using it* but also because of how often current Italian leader *Giorgia Meloni* rolls it out.

Prime Minister Meloni's economy is on somewhat of a roll. Though the *eighth-biggest* economy grew just *0.8% y/y* during Q4, other indicators suggest Italy entered this year on firmer footing. Case in point: Italy surpassed Japan in exports by volume for the first time in more than 50 years.

Using the Japanese economy as a benchmark helps to illustrate how the Italian economy is taking off, relatively speaking. Let's discuss why Italy is having a moment and whether it can continue:

(1) *Beating Japan Inc.* Some of *Italy's $376 billion* of overseas shipments from July to December—versus Japan's $370 billion—could indeed be thanks to the disruptive impact of

US tariffs. But it also owes much to Italy's promotion of an eclectic mix of exports and policies to help small and mid-size enterprises sell abroad. This focus on bottom-up trade contrasts wildly with Japan's top-down export model.

In February, Italian consumer confidence rose for the third consecutive month *to 99.1*. That's nearly two full points above the 2025 average, as households report feeling better about current and expected economic conditions.

(2) *Riding defense wave.* Italian industry is also well positioned to ride that wave of increased defense spending by key neighbors, including Germany. Since the attacks on Iran, shares in Italian defense groups like *Leonardo* and Fincantieri have been in the spotlight. Italy is also enjoying the spillover effects of increased infrastructure investment in Europe's largest economies.

Success in diversifying Italy's export mix led Meloni to resurrect the idea of a transatlantic free-trade zone. At the moment, European Union members are caught between an aggressive Russia, US President Trump's tariffs, China's overcapacity, and now the fallout from the US-Israeli strikes against Iran.

Even before the Supreme Court struck down Trump's authority to impose tariffs, Meloni was stepping up efforts to "move toward a free-trade area" with the US, Italy's No. 2 export destination.

(3) *Free-trade push.* Meloni *told Bloomberg* last week: "I consider the tariffs between Europe and the US a mistake. We should go in a diametrically opposite direction." She added that Rome has "tried to ease the situation as much as possible, in short, to seek an agreement that's sustainable and reasonable."

Of course, the US-Israeli offensive may complicate what's possible on the trade deal front for some time. As Trump said Monday, "We projected four to five weeks, but we have the capability to go far longer than that. Whatever the time is, it's OK. *Whatever it takes*."

(4) *Wake-up call.* Amid global risks, Team Meloni must accelerate moves to increase the *lowest productivity* rate among the major EU economies, a high debt-to-GDP ratio of *roughly 137%*, and a shrinking workforce.

That's true for Europe broadly, too. As regional leaders grapple with trade war fallout, few have found the bandwidth to streamline regulations, tackle the drivers of high labor costs, address ageing populations, and accelerate AI adoption.

One of the continent's bigger ideas for 2026 is a "*Made in Europe*" push that, so far, has largely been about China. It would champion strategic industries and tighten foreign investment rules so that mainland companies can't tap the *450 million* consumer EU market without sharing the profits.

(5) *Made in Europe.* The enterprise is currently stuck in the usual *France-Germany debate* zone. French President Emmanuel Macron favors a Made *in* Europe scheme geared to "protecting our industry." German Chancellor Friedrich Merz's government prefers a Made *with* Europe model that promotes competition based on increased innovation and productivity.

Adding to the drama, the UK has been *lobbying* Italy, Germany, the Netherlands, and others to oppose France's proposal to exclude post-Brexit Britain altogether.

Yet as China speeds up the world's economic clock, Europe doesn't have a moment to waste in acting to increase living standards and competitiveness. That goes, too, for Meloni's whatever-it-takes premiership. Even if Italy is on an export roll, sustaining the *24% gain* in the FTSE Italia All-Share Index over the last 12 months requires bold steps to build on the success.

Strategy: Widespread Q4 Growth Lifts S&P 500 EPS to New High. With 97% of the S&P 500 companies having reported December-quarter results, we can assume we've got the scoop on their aggregate performance. Nearly all sectors participated to carry S&P 500 EPS to a new record high of $73.03 based on "blended EPS" (a mix of actual EPS for companies that have reported and consensus estimates for those that haven't) (*Fig. 1*). That exceeds the index's prior record-high of $72.77, in Q3-2025, by a slim 0.5%.

S&P 500 earnings were 5.1% ahead of analysts' consensus forecasts at the time of companies' respective reports—better than the 3.6% average surprise in the 156 quarters since Q1-1987 but not as good as Q3's 9.9% beat, a 16-quarter high powered by too-low estimates amid tariff uncertainty (*Fig. 2*). For another perspective on the surprise: Just before reporting season began, analysts' consensus estimates implied aggregate EPS of just $70.62, a couple of bucks too low (*Fig. 3*).

The S&P 500's blended y/y earnings growth rate for Q4 is 12.4%, marking a fifth straight quarter of double-digit growth and a 10th quarter of positive growth (*Fig. 4*). During Trump's first term, S&P 500 earnings rose y/y for 12 straight quarters through Q3-2019.

Viewing growth through a different lens, S&P 500 earnings rose 14.3% y/y in Q4 on a proforma same-company basis (*Fig. 5*). That also marked marking a fifth straight quarter of double-digit growth and a 10th quarter of positive growth.

How did the S&P 500's 11 sectors do last quarter? Below, Joe reviews our "S&P 500 Forward Metrics & Fundamentals" *web pub* and puts their aggregate Q4 results under his analytical lens:

(1) *Few sectors driving S&P 500's earnings growth, but nearly all rose y/y.* During Q4, ten of the 11 S&P 500 sectors delivered rising earnings y/y, but just three beat the S&P 500: These three sectors posted record-high EPS: Communication Services, Industrials, and Information Technology. These three remained close to their records highs: Consumer Staples, Financials, and Real Estate.

Five sectors recorded double-digit percentage y/y earnings growth in Q4, up sharply from just two sectors in Q3. Q4's sole laggard by that measure was Consumer Discretionary, falling y/y for the first time in 12 quarters.

On the bright side, Energy's earnings rose y/y for the first time in six quarters and only the second time since Q2-2023. Financials rose for a 12th quarter, and Information Technology an 11th, but the latter has shined with its last 10 quarters at a double-digit percentage rate. Thanks to tariffs, the long suffering Materials sector has now posted two quarters of double-digit earnings growth for the first time since Q2-2022.

Here's the Q4 y/y (proforma) earnings growth rate derby: Information Technology (33.8%), Industrials (17.2), Communication Services (14.6), S&P 500 (14.3), Materials (13.1), Financials (10.4), Consumer Staples (3.7), Energy (3.6), Utilities (3.6), Real Estate (2.0), Health Care (0.9), and Consumer Discretionary (-0.2).

(2) *More sectors growing revenues faster than the S&P 500*. Four sectors recorded double-digit percentage y/y revenues growth in Q4, double the prior quarter's number and matching the highest count since Q4-2022. Only Energy lagged, having suffered y/y revenue declines in nine of the past 12 quarters.

These five sectors posted record-high revenues: Communication Services, Consumer Discretionary, Health Care, Industrials, Information Technology, and Real Estate. These three remain close to their records highs: Consumer Staples, Financials, and Utilities.

Here's the y/y revenues growth tally: Information Technology (21.4%), Utilities (11.4), Communication Services (10.9), Health Care (10.9), S&P 500 (9.0), Real Estate (8.6), Industrials (8.5), Financials (6.7), Consumer Discretionary (5.6), Consumer Staples (4.2), Materials (4.1), and Energy (-0.2).

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